Panel 3

Challenges for Europe's political institutions and society

Introduction

Donald R. Davis
Professor, Columbia University, New York

Something there is that doesn't love a wall: An american perspective on the economics of immigration

Something there is that doesn't love a wall,
That sends the frozen-ground-swell under it,
And spills the upper boulders in the sun,
And makes gaps even two can pass abreast.
Mending Wall, Robert Frost

Robert Frost's poem, *Mending Wall*, popularized the proverb "Good fences make good neighbors." Yet this phrase fails to capture the richer imagery of fences and neighbors in Frost's words. The poem treats the case of two New England farmers walking a stone wall between their fields to repair Winter's depredations. It begins with the observation "Something there is that doesn't love a wall." Of course, for Germans and for Europeans, the observation that even the greatest wall is fragile is not news. My aim is to use the framework of economics to illuminate the forces that tear walls down and to consider these in the United States context, with the hope that there are useful insights beyond the US context.[1]

One of Frost's farmers suggests, impishly, that the walls are torn down by elves. In our world, elves are replaced by the invisible hand of trade, cross-country investment, and immigration. It is the last of these forces – immigration – upon which I will focus my attention. Of course, immigration itself responds to various motives, including security, freedom, and economic gain. Again, it is the last of these – the *economics* of immigration – to which I will attend.

The deceptively simple economics of immigration

On the surface, the economics of immigration could not be simpler. Immigrants move in order to earn the high wages available outside, but not inside, their country. That much is straightforward. However, if we want to understand the economic consequences of this migration, we are obliged to be more explicit about *why* wages differ.

Immigration: The Labor Shortage Model

In the context of immigration, educated public discussion of why wages differ across countries is overwhelmingly, nearly exclusively, dominated by a single framework – one we can call the labor shortage model. That is, wages are high in the countries that receive immigrants because labor is scarce there.[2]

The labor shortage model of immigration has many merits. It is thoroughly intuitive to anyone who grasps the elements of demand and supply. It yields interesting predictions about gains and losses for the world as a whole and for natives of each country, as well as providing a provocative perspective on the political economy of immigration.

In its most conventional form, immigration in the labor shortage model has the following consequences:

- World income rises by a *large* amount if the initial wage gap is large – the invisible hand is at work!
- In the country receiving immigration:
  - Natives of the receiving country, taken together, receive a *small* gain in total income.

[1] A Google search of *Mending Wall* and immigration will find many hits. It is unfortunate how much emphasis has been placed on the role of fences in neighborliness; Frost's actual point seems to the contrary. His narrator notes: "Spring is the mischief in me, and I wonder/If I could put a notion in his head:/'Why do they [fences] make good neighbors? Isn't it/Where there are cows?/But here there are no cows."

[2] Very interesting surveys of the labor literature on immigration can be found in Borjas (1994, 1999) and Lalonde and Topel (1997).

– There is a *large* redistribution of income away from labor (e.g. toward owners of capital). Wages fall.
• In the country that is the source of the migrants:
– Natives of the source country, when we include the migrant in the calculation, receive a *large* gain in total income.
– Those natives left behind, taken together, suffer a *small* income loss.
– There is a *large* redistribution within the source country toward labor (e.g. away from owners of capital). Wages rise.

The emphasis on the impacts that are large versus small is quite important. The effects on wages and internal income distribution suggest that labor should favor immigration in the low-wage source country, but oppose it in the high-wage destination country. Vice versa for owners of capital. And these should be relatively robust. The fact that aggregate gains in the receiving country are small and likewise for those staying behind in the source country suggests that other factors could dominate these effects. Just as an example, the net fiscal costs of immigration (positive or negative) could swing the aggregate impact on a country in either direction.

We should emphasize one additional important aspect of the labor shortage model – an aspect that at first seems counter-intuitive. If the country receiving the immigration is to receive gains in the aggregate, it is essential that immigration lead wages to fall there. As noted, this seems counter-intuitive, since falling wages would seem to be a source of loss for the receiving country, not gain. The paradox is resolved by recognizing that the falling wages imply that the labor flowing in captures less than all of the gains in income these flows create. Native workers of the receiving country do experience losses as their wages fall. But this is then more than compensated by the increased income of other factors in the receiving economy.

The labor shortage model of immigration has many merits. However it also has a serious shortcoming: It is at best incomplete and may even miss the central story of immigration. To understand why, we need to probe just a little deeper into the labor shortage framework. As conventionally developed, the only dimension in which source and destination countries differ is in the relative availability of labor. Because of this, the high wage paid to labor translates to low returns to some other productive factor in the economy (e.g. capital, land, or a grade of labor other than that considered as migrating). If labor wants to enter because of unusually high wages, some other productive factor has to want to leave because of its own unusually *low* returns.

The labor shortage model, taken alone, flies in the face of the facts in the United States case. The United States is an importer of unskilled labor, but it is also an importer of skilled labor and capital. Moreover, were it free to move, the United States would also almost surely be an importer of land! It seems implausible on its face that the United States has a shortage of skilled labor (of which it is an importer). The labor shortage model, by itself, cannot explain why all factors want to move to the United States. To explain this, we will have to turn to alternative models. Importantly, the economic consequences of these alternative models are quite distinct from those of the labor shortage model.

Immigration: Alternative models of technology and scale

The labor shortage model is at best incomplete and quite possibly misses the central factor motivating economic migration – the *technological advantages* of advanced economies that are the likely cause of wage differences. This alternative perspective on the roots of migration matters because the economic consequences of migration can be quite different when this responds to technological differences rather than labor shortages. If all factors are more productive in some countries than in others, then this productivity advantage could explain why the returns to all types of labor and to other factors is higher there, hence invite inflows of all factors from abroad. For the moment, we will ignore *why* some countries are more productive than others – the higher productivity could reflect technology per se; business organization and culture; returns on infrastructure; political institutions; public health conditions; or other factors. These need not concern us (although these questions are certainly important!). However, we will need to discuss two cases, which turn on whether or not the *scale* of the economy itself affects productivity.

We consider this first within the simplest possible framework, one essentially identical to that in which David Ricardo demonstrated the Law of Com-

parative Advantage.[3] Here scale per se does not affect productivity. Consider two countries, England and Portugal, producing two goods, cloth and wine. For simplicity, let England have an absolute (as well as comparative) advantage in the production of cloth, and similarly let Portugal have an absolute (as well as comparative) advantage in the production of wine. Suppose that the technological superiority of England in the production of cloth (combined with adequate world demand for cloth) leads English wages to exceed those in Portugal under free trade. Then, other considerations aside, Portuguese labor would have an incentive to migrate to England.

If such migration is allowed, who gains and who loses? In parallel to our earlier discussion in the labor shortage model, we can answer this for a *technological advantage* model:

- World income rises by a *large* amount if the initial wage gap is large – the invisible hand is at work!
- In England, which receives immigration:
– The real income of English workers falls for sure.
- In Portugal, which sends migrants:
– The real income of Portuguese workers (including migrants) rises for sure.

It is worth looking closely at both similarities and differences in the consequences of migration in comparing the *labor shortage* and *technological advantage* models. Note that both models suggest that migration raises income for the world as a whole. Adam Smith would have asserted the influence of the invisible hand. Robert Frost would have noted "something there is that doesn't love a wall" – viz. wage differences! However the two frameworks differ sharply in how the gains to world income from migration are shared between the source and destination countries. In the labor shortage model, natives of the receiving country do gain in the aggregate, even if those gains are small. In the technological advantage model, natives of the country whose technological strength initially gave it high wages have large *losses* from immigration. One can think about the source of those losses from a variety of perspectives. A first perspective is just demand and supply. As Portuguese labor flows in, English production of cloth expands and Portuguese production of wine diminishes, reducing the price of cloth in terms of wine and dragging English wages down. Alternatively, one can note that England's initial high wages are tied to its posited technological advantage in cloth. In effect, England initially has a monopoly access to the good technology for cloth which is eroded as Portuguese labor flows in and uses this technology. England's losses, from this perspective, come from the loss of monopoly access to a superior technology.

The contrast between the labor shortage and technological advantage models of migration are thus quite sharp. The labor shortage model suggests that migration is like trade – natives of both countries gain. By contrast, the technological advantage model suggests that this is quite misleading – that while migration raises world income, more than all of this gain is captured by natives of the source country and natives of the country receiving immigration actually lose.

We return for a moment to consider the role of scale in the technological advantage model. Thus far we have assumed that as labor flows to England, the productivity of the English cloth industry is not changed (although the terms at which cloth is traded for wine decline). One could consider instead the possibility that by expanding the scale of the English cloth industry, immigration may actually raise productivity. As Adam Smith noted, the degree of division of labor is limited by the scale of the market. At least in principle, the inflows of migrants, even in response to technological advantage, could so raise productivity in English cloth that English wages rise in spite of any decline in terms of trade. In addition, if the inflows lead to the introduction of new varieties of cloth, it is possible that the terms of trade losses that are the source of English woes may be muted or non-existent. This would be consistent with the models of economic geography that Paul Krugman and other have championed in recent years. We return to these questions in the discussion of what economists have done to examine these issues in the data.

The impact of immigration in the data

In this section we will discuss selected empirical work that seeks to understand the economic impact of international migration. This is overwhelmingly focused on the labor shortage model. We will also summarize an empirical project examining the consequences of considering this instead from a technological advantage framework.

[3] Both Findlay (1982) and Trefler (1997) comment on the losses in the receiving country from immigration in a classic Ricardian model, although neither tied this to the many-factor case of our own world or contemplated the United States as such a case.

Immigration in the data: The labor shortage model

Some of the early empirical work on the impact of immigration on wages in a labor shortage framework had a surreal quality. Let me use an analogy. Suppose we were interested in whether dumping an elephant into a pool would raise the water level. With suitable coaxing, we get the elephant to launch into the pool. Then we employ the following methodology. We use extremely precise instruments to examine the question of whether the water level is higher in the area of the pool into which the elephant has been launched than it is in other areas of the pool. If we find that the water is not significantly higher (in the statistical sense) in the area of the pool where the elephant sits than in other areas, we conclude that the elephant had no impact on water levels. This is scarily similar to a great deal of the early literature on the economic impact of immigration. That literature looked at whether wages were unusually low in areas where immigration was particularly concentrated. Most studies could find little impact of immigration (*qua* elephant) on the labor pool. The list of reasons why this might be true is legion, *inter alia* the possibility that there might be accommodating labor outflows, capital inflows, or changes in the composition of production.

More recent work in a labor shortage framework, particularly by George Borjas, has made important adjustments. Rather than look for impacts in local labor markets, where these can easily spill over to other labor markets, it looks for a national impact. In addition, rather than look for impacts on broad classes of labor, it stratifies those labor classes as well by years of experience, on the premise that within a class of labor those with similar levels of experience are closer substitutes. This is also important because immigrants are not evenly distributed across cohorts within each labor class. The main result of this work is that it is possible to identify a significant impact of immigration in lowering wages. While this is clearly bad news for labor that competes head to head with the immigrants, remember that such wage declines are also the *necessary* condition in the labor shortage model for the country receiving immigration to experience *aggregate* gains in income.

Immigration in the data: The technological advantage model

Countries differ tremendously in their aggregate productivity and indeed this is almost surely the main reason that wages differ across countries, hence also a prime reason for migration. When considering the US case, it is a net importer of unskilled labor, in which it is plausibly scarce. But it is also an importer of highly skilled labor, in which it is not plausibly scarce. It is also a major importer of capital. The advantages of highly productive technology provide a simple explanation for these coordinated movements.

We saw that the simplest model of migration based on technology differences and a single factor ("labor") yielded losses for the destination country. The same point goes through just as before if it is legitimate to think of all factors moving into the United States proportionally. Davis and Weinstein (2002) focused on the consequences of such coordinated inflows and showed that inflows at a single common rate is surprisingly close to what actually happened. In 2002, fully 14.3 percent of the US labor force was born outside the country while capital inflows accounted for 16.5 percent of the US capital stock. Roughly, the inflows of the two combined made the US economy 15 percent larger than it would otherwise have been.

We have indicated before that the consequences of such growth depend on the resulting impact on the terms of trade. Acemoglu and Ventura (2002) provide exactly the kind of exercise that is necessary to make sense of this. They started out with the observation that, although different countries had very different growth rates over long stretches of time, the world income distribution remained quite stable. Their explanation was that countries that grew faster suffered terms of trade losses passing part of their gains to the rest of the world. But this also provides the kind of estimates Davis and Weinstein needed to calculate the losses from migration. Davis and Weinstein estimate the costs of these inflows in two ways. One treats the United States as producing a composite good to which the inflows of labor and capital contribute. The other disaggregates and looks at the impact of these inflows (which are not precisely proportional across all categories of labor) on the composition of output. The calculations suggest that the aggregate cost to the United States in 2002 was between $50 and $100 billion.

Immigration in the data: Alternative models

Recently Gianmarco Ottaviano and Giovanni Peri (2005) developed a third approach. Their work

focuses on two main ideas. One is that foreign labor substitutes imperfectly for US labor, both across and within labor classes. Across labor classes, there is less than a perfect match between the proportions of foreigners in the labor force and that of US natives. Within a labor class, the foreign worker may bring unique skills that are complementary (rather than substitutable) to those of native workers. The second idea is that the inflows of labor may stimulate the accommodating accumulation of capital that keeps wages from falling.

This line of work seems promising and we will only note some caveats. The endogenous accumulation of capital that they appeal to as helping to hold wages up is not always a positive. As stressed in the technological advantage discussion above, this accumulation (from sources at home or abroad) could make the receiving country's output relatively abundant in the market, which could then depress its price (also limiting the extent of the accumulation). A second caveat comes from a recent study of Borjas (2006), who looked at the impact of immigration to the United States in high skill labor markets on the wages of participants in those markets. One might imagine that the high skill market would be precisely the kind where the novel ideas of foreign workers might give rise to complementarities with their counterpart high skill natives. Borjas finds instead that a 10 percent increase in the supply of foreign high skill workers depresses the wages of high skill US counterparts by 3 to 4 percent.

Conclusions

Even as we write, the United States is going through a convulsive discussion of the future of immigration. The President, Senate, and House are in a dance over legislation that could greatly affect the estimated 11 million immigrants in the United States without documentation. Meanwhile an immigrants rights movement has emerged with great power and vehemence. Some elements of that movement are using the traditional May 1 worker celebration for a day of economic boycott to demonstrate the power and importance of immigrant workers.

The jury is still out on the economic impacts of immigration. Even the more negative view of the aggregate impact on the US economy, as developed in Davis and Weinstein (1992), is ultimately not of overwhelming magnitude. The losses considered therein are almost surely dwarfed by the gains reaped by the immigrants themselves. In this respect, maintaining relative openness to immigration may well be the largest form of overseas assistance the United States engages in. While contested, right now the evidence seems to suggest that there really are some significant losses for specific groups that compete most closely with immigrants, particularly unskilled workers. However, given the stakes for the immigrants themselves, it is not clear that limits on immigration are in any way a preferred mode of support for this group. There may be many more direct paths that can be taken.

The recent events in the United States, like those earlier this year in Paris and beyond, have underscored that the issues at stake are economic, but they are also much more. They are about social inclusion. They are about opportunity. They are about helping peoples in our midst to see a path forward to becoming full members of our societies. Near the close of his poem "Mending Wall," Frost writes:

"Before I built a wall I'd ask to know
What I was walling in or walling out,
And to whom I was like to give offence."

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Panel

Also represented on the panel, which was chaired by **Robert Thomson,** Editor-in-Chief, *The Times,* London, were personalities from politics and business.

Martin Bartenstein, Austria's Federal Minister of Economics and Labour, represented the country that has gained more immediate neighbours from European enlargement than any other EU country. It was encouraging to hear him say that his country is a clear winner of EU enlargement with an additional 3.5 percent of GDP and a net gain of 77,000 jobs. Austria is also the largest investor in Slovenia, Romania, Bulgaria, Croatia, Serbia and Bosnia and the number three investor in Hungary, the Czech Republic and Slovakia. He emphasised that enlargement has also benefited Europe as a whole: the income gap between the old and new members has narrowed, and the new members have provided additional growth dynamics to the European economy. In addition, the national reform programmes for the second phase of the Lisbon strategy are all in place – Europe is moving in the right direction but must remain on course.

Didier Lombard is Chairman and Chief Executive Officer of France Telecom, a company active in more than 200 countries. He observed that EU Enlargement has given his company greater access to managers in the new member states, whose new, dynamic management culture is making an important contribution to France Telecom as a whole. In his opinion, one way to counter the wide-spread insecurity regarding the future is by stepped-up, product-based research and investment. His company would also benefit if the EU provided a new framework for competition. Rules on competition adapted to the world in which we are living would considerably improve the investment climate. Finally, he advised politicians to avoid talking about "big reforms", which helped trigger the recent strike over the First Employment Contract (CPE) legislation in France. Step-by-step changes without using the "reform" label may be the better course of action.

Günther H. Oettinger, Minister-President of the state of Baden-Württemberg since April 2005, identified new areas that call for action as the result of European enlargement and globalisation. He sees a critical problem in the state of education: too many children are not prepared for occupational training; too many students are not preparing themselves for the jobs of tomorrow. Research and innovation is not receiving the necessary support in Europe. Germany in particular needs more market incentives in the areas of infrastructure, education and health. In his view, it is also problematic that the voting population is not fully aware of the difficulties we are facing. Angela Merkel lost the election and had to form a coalition government with the Social Democrats because she was relatively honest with the voters on the issue of taxation. "In all the large economies in Europe, the problem is not only a failure to act but also a lack of awareness", Oettinger concluded.

James W. Robinson is Senior Vice-President of the US Chamber of Commerce. His organisation is currently producing a booklet on the benefits of global engagement, immigration and trade. He stressed that it is vital to influence public opinion on this point, especially to counter the current backlash on the issue of immigration in the United States, for which there are no compelling macroeconomic reasons. He proposed four ways to meet the challenges of immigration: 1) Create a path of economic mobility and social advancement through small business entrepreneurship and job creation. Here the U.S. is leading the way with small businesses owned by women and minorities being created at twice the rate of business start-ups in the economy as a whole. 2) Continue to reduce commercial barriers and other impediments to global growth. This is the only way to correct income inequalities in neighbouring countries and to reduce migratory pressure. 3) Access to quality education at all levels is fundamental to creating a level playing field for all individual and communities within our societies. Expanded access to education, more than any other single factor, has helped blur the lines of class, race, sex and ethnicity in the U.S.. The failings of many schools today is a recipe for disaster in a knowledge-based economy. 4) A definition of citizenship is needed that balances national identity with cultural diversity. An open society will not be afraid to ask all residents to play by the rules, obey the law and work together for the betterment of their country.